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No. 91-642

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR PETITIONER

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January 2, 1992

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REPLY MEMORANDUM FOR THE PETITIONER

This reply to the Commissioner's brief in opposition is filed for two reasons. First, the Commissioner has failed to reconcile the decision of the Court of Appeals for the Second Circuit in the instant case with the conflicting decision of the Court of Appeals for the Fifth Circuit relating to whether a valuation overstatement penalty is appropriate when a tax deduction is totally disallowed for a reason completely unrelated to the value of the property.[1] Second, the Commissioner has failed to reconcile the decision of the Court of Appeals in the instant case with conflicting decisions by the Court of Appeals for the Sixth Circuit as to whether it is proper to rely on subjective predictions of uncertain future economic events to determine if a speculative business transaction providing tax benefits is a sham. In the interests of consistent, equitable and predictable treatment of taxpayers, this Court should grant Gilman's petition to clarify (1) the proper application of the valuation overstatement penalty, and (2) the proper legal standard for determining if a transaction is a sham.

ARGUMENT

POINT I.

The Commissioner Fails to Reconcile the Decision of the Court of Appeals in This Case with *Heasley* and *Acker*.

The decision of the Court of Appeals for the Fifth Circuit in *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), cannot be reconciled with the conflicting decision by the court of appeals below with respect to the valuation overstatement penalty under section 6659. In *Heasley*, as in this case, the Commissioner completely disallowed all tax deductions from a transaction because it was not entered into for

1 Terms used in this reply, unless otherwise noted, shall have the same meaning as in Gilman's petition for a writ of certiorari.

profit. The Court of Appeals for the Fifth Circuit held that the valuation overstatement penalty does not apply where a tax deduction or credit is totally disallowed, regardless of the reason for the disallowance.[2] If all tax deductions are disallowed for reasons unrelated to the value of property, the resulting deficiency cannot be "attributable to a valuation overstatement"—an explicit statutory requirement of section 6659. In reaching a contrary result, the Court of Appeals for the Second Circuit's decision in this case is squarely in conflict with the decision of the Court of Appeals for the Fifth Circuit in *Heasley* and the language of section 6659. Therefore, the Commissioner's assertion that *Heasley* may somehow be distinguished is without merit. The Commissioner's contention that there is no conflict in the circuits is nothing more than a convenient litigating position. The Commissioner himself conceded that such a conflict exists in his nonacquiescence to the decision of the Court of Appeals for the Fifth Circuit in *Heasley*. The Commissioner stated: "[w]e continue to believe that the [Second Circuit] standard is correct and that the oversimplified approach of the Fifth Circuit [in *Heasley*] does not properly reflect the language or purpose of the statute." Action on Decision CC-1991-013 (July 3, 1991). In his brief in opposition, the Commissioner made no attempt to reconcile his official nonacquiescence to the *Heasley* decision with the position he is taking in this Court.

Further, the Commissioner's argument that *Commissioner v. Acker*, 361 U.S. 87 (1959), is distinguishable is based on an erroneous legal premise. The Commissioner argues that

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2 The Tax Court in *Heasley* imposed the valuation overstatement penalty for two reasons. First, it found the taxpayers had overvalued their property by more than 2,000 percent, and second, it found the transaction had no profit potential. *Heasley v. Commissioner*, 55 T.C.M. (CCH) 1748, 1752 (1988), *rev'd*, 902 F.2d 380 (5th Cir. 1990). Despite the clear valuation overstatement, the Court of Appeals for the Fifth Circuit reversed the Tax Court and refused to impose the penalty under section 6659. Gilman's case against imposition of the overvaluation penalty is even more compelling than in *Heasley*. In Gilman's case there was no factual finding that the actual value of Gilman's equipment was inflated at all. The only finding was that Gilman's transaction had no "reasonable" profit potential.

when a purchase of property is treated as a sham, the purchase of the property is respected, but the price paid to purchase it is simply disregarded. Opp. Brief 13-14. That is wrong. When a transaction is characterized as a sham, it is disregarded in its entirety because the tax law treats the transaction as if it never occurred at all. *See Knetsch v. United States*, 364 U.S. 361, 366 (1960). If Gilman's transaction was properly characterized as a sham, then for tax purposes he is treated as if he never purchased the equipment at all. In that case, Gilman owned no equipment which he overvalued.

The statute at issue in *Acker* was intended to penalize taxpayers who affirmatively underestimate their tax liability. The Commissioner attempted to apply the statute on a strict liability basis, penalizing taxpayers who made no estimate of their tax liability at all. This Court rejected that approach. Similarly, section 6659 was intended to penalize taxpayers who affirmatively overstate their actual tax basis in property. Yet, the Commissioner is applying this section on a strict liability basis to penalize taxpayers who have no tax basis in property to overstate. That result in the instant case is fundamentally inconsistent with the rule in *Acker*—that penalty provisions are to be strictly construed.

POINT II.

The Commissioner's Argument That the Decision in This Case Does Not Conflict with *Smith* and *Bryant* Is Without Merit.

A. Gilman's Transaction Was Not a "Mere Paper Shuffle"—It Had Practicable Economic Effect on Him.

The Commissioner does not dispute the fact that there is a clear conflict between the Courts of Appeals for the Sixth Circuit and the Second Circuit regarding the legal standard used to distinguish transactions having economic substance from those that do not. The Commissioner's only argument is that Gilman's transaction was merely "paper shuffling" to be treated as a sham under any legal standard because no "reasonable person" should have predicted in 1980 that Gilman's equipment would have any measurable residual

value nine years later. Opp. Brief 10. The Commissioner is wrong when he assumes that residual value was the only economic attribute of Gilman's transaction. In fact, the residual value of an investment is only one of a number of economic attributes which establish economic substance in the Sixth Circuit. Under *Bryant v. Commissioner*, 928 F.2d 745 (6th Cir. 1991), and *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991), a transaction has economic substance if it may have "*any* practicable economic effect" on the taxpayer other than tax reduction. *Smith*, 937 F.2d at 1096 (emphasis in original) (quoting *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989)).

Under that analysis, Gilman's transaction had practicable economic effect on him in several ways. First, Gilman became personally liable to repay more than $2.3 million of debt he incurred to finance the equipment—debt he owed whether or not his lessee paid rent or the equipment maintained its value.[3] Gilman's risk of repaying that amount out of his own pocket cannot be disregarded as mere "paper shuffling." Second, Gilman leased the equipment to an unrelated lessee for rent that would total more than $6 million. That amount, if Gilman received it, would be used to repay his acquisition debt and provide him with over $75,000 of cash flow. Gilman's benefit from earning that amount of

3 Gilman was personally liable to repay almost $2 million of the debt he incurred to purchase the equipment. In addition, he signed short term notes backed by letters of credit to secure his obligation to pay $375,000 of interest on the debt. Yet the Commissioner implies that the debt lacked economic effect because (1) Gilman could defer payment of a portion of his debt if his lessee failed to make its lease payments, and (2) the amount of Gilman's debt service and the amount of his anticipated rental income were similar. Opp. Brief 3 n.2. The Commissioner is wrong for several reasons. First, the deferral of a debt payment is not equivalent to its cancellation. The full amount is simply payable at a later date. *See, e.g.*, *Smith*, 937 F.2d at 1094-95. Second, the fact that rental income is expected to be similar to debt service does not negate the potential economic effect of either. In *Frank Lyon Co. v. United States*, 435 U.S. 561, 571 (1978), this Court respected a similar leveraged lease transaction even though the taxpayer's expected rental income was *exactly equal* to the taxpayer's debt service.

rental income—an amount sufficient to pay interest and principal on more than $2 million of his recourse debt obligation and to generate over $75,000 of cash flow—cannot be disregarded as mere "paper shuffling." Finally, whether or not it was reasonable in 1980 to predict a large or small residual value for the equipment, the facts remain that (1) no one in 1980 could predict the residual value with any degree of certainty, and (2) whatever the residual value ultimately turned out be, it belonged solely to Gilman. If it were large he would have a profit. If it were small he would have a loss. Such an economic variable, dependent as it is on uncertain future events, cannot be disregarded as mere "paper shuffling."[4] Gilman's transaction had economic substance under the analysis applied by the Court of Appeals for the Sixth Circuit.[5]

B. Speculative Transactions Should Be Characterized Using the Objective Criteria Under Section 183, Not Subjective Predictions of Uncertain Economic Results.

The Commissioner's argument that the transaction could have no economic effect on Gilman because it was "unrea-

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4 At trial, the Commissioner's expert testified he would have predicted little or no residual value. Gilman's expert had predicted a residual value of at least $600,000. The Tax Court accepted the prediction of the Commissioner's expert as being "more reasonable." Pet. App. 41a. The Tax Court's finding is not at issue in this appeal. At issue is the fact that the Commissioner never asserted, and the lower courts did not find, that no profit was conceivable, only that a profit was "unreasonable" to expect. Pet. App. 41a. In the Sixth Circuit, however, a sham transaction is one in which profit is inconceivable. *See, e.g.*, *Rose v. Commissioner*, 868 F.2d 851, 852 (6th Cir. 1989) (property purchased for over $1 million in purported notes at a time when its value was negligible).

5 *See Bryant v. Commissioner*, 928 F.2d 745, 749 (6th Cir. 1991) (economic substance present where taxpayer invested substantial borrowed funds and some income actually generated from the transaction, even though expectation of any profit was unreasonable); *Smith v. Commissioner*, 937 F.2d 1089, 1092, 1095 (6th Cir. 1991) (economic substance present where taxpayer invested substantial funds borrowed on a recourse basis which would be repaid with future income, even though the transaction was highly unlikely to be profitable).

sonable" for Gilman to predict any "measurable" residual value for the equipment vividly illustrates the conflict between the circuits that this Court should resolve. Opp. Brief 5, 10. Should the tax consequences of a speculative transaction be based upon subjective predictions as to a reasonable expectation of profit? The Court of Appeals for the Second Circuit held such predictions to be controlling. Pet. App. 10a-11a. The Court of Appeals for the Sixth Circuit rejects that very approach and applies the objective criteria under section 183 and the Treasury regulations promulgated thereunder instead. *Smith*, 937 F.2d at 1096-97; *Bryant*, 928 F.2d at 750.

This Court has never relied on speculative predictions of uncertain future economic events to characterize a transaction. In fact, comparing the transaction characterized by this Court in *Knetsch v. United States*, 364 U.S. 361 (1960), with the transaction in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), illustrates that objective economic and legal criteria determine the tax characterization of a transaction, not subjective predictions of uncertain future economic events. This Court held that the transaction in *Knetsch* had no economic substance and was a sham. Knetsch purportedly borrowed $4 million on a nonrecourse basis from an insurance company at 3½% to buy a $4 million insurance policy from the same insurance company. The policy increased in value each year by 2½%. Each year, however, Knetsch would make an "interest payment" to the insurance company and then borrow it back again on the same terms as the original debt, maintaining a net equity in the policy of exactly $1,000. Knetsch had no economic risk of loss from the transaction since his indebtedness was completely nonrecourse, secured only by the policy his lender sold him. Knetsch had no profit potential because he was never entitled to receive more than $1,000 in return for his much larger cash investment.

In *Frank Lyon*, this Court upheld the characterization of a transaction, the economic attributes of which were in direct contrast to the "paper shuffling" transaction in *Knetsch*.

Lyon bought property to be leased. Lyon paid for it with recourse debt which Lyon was legally obligated to repay—even if its lessee did not pay rent and the property became worthless. When Lyon bought the property its residual value, if any, could not be predicted with any degree of certainty. As in the instant case, the Commissioner in *Frank Lyon* sought to recharacterize the transaction for tax purposes based upon predictions of future economic events. He argued that: (1) Lyon's lessee would make all rent payments required under the lease so that Lyon would not have to repay its acquisition debt with its own cash, and (2) Lyon's residual value could be accurately predicted. This Court rejected the Commissioner's reliance on such predictions in characterizing Lyon's transaction.

The economic substance of Gilman's leasing transaction is analogous to Lyon's leasing transaction. It is in stark contrast, however, to Knetsch's paper shuffling sham transaction. Gilman bore material downside risk to repay money borrowed to purchase his property. He owed that money to his lender regardless of whether his lessee paid rent or the value of the property declined. Gilman would benefit from any residual value of his property upon termination of its initial lease. Whatever it would be worth at that time belonged to him. As in *Frank Lyon*, but in contrast to *Knetsch*, no one in 1980 could know with certainty whether Gilman's transaction ultimately would be profitable or not.

In *Bryant* and *Smith*, the Court of Appeals for the Sixth Circuit rejected the "reasonable possibility of profit" standard that the Court of Appeals for the Second Circuit applied to Gilman. In doing so, the Sixth Circuit rejected the use of uncertain economic predictions in favor of the objective standards in the Treasury regulations under section 183. The Court of Appeals for the Second Circuit refused to apply the same objective standards to Gilman.

C. Taxpayers Are Entitled to Know the Tax Consequences of Prospective Tax Benefit Transactions Before They Invest in Them. They Should Not Be Second-Guessed By the Commissioner Based on Uncertain Predictions of Future Economic Results.

In addition to resolving the undisputed conflict between the Courts of Appeals for the Second and Sixth Circuits, sound tax policy justifies granting Gilman's petition. The Commissioner's narrow view in this case ignores the reality that many contemporary business transactions are speculative and involve high risk of loss. Congress has enacted tax benefits to induce investment in certain of those transactions. Those tax benefits are intended to ameliorate possible after-tax loss and enhance potential after-tax profit. Accelerated depreciation deductions for equipment lessors like Gilman are just such a congressionally-bestowed tax benefit. Taxpayers considering investments in such speculative and high-risk "tax benefit" transactions must be afforded some degree of certainty as to the transactions' tax consequences. They should not be forced to evaluate potential investments based upon whether the Commissioner, in retrospect, might conclude they made an unwise investment. *Smith*, 937 F.2d at 1096; *Bryant*, 928 F.2d at 749. That is particularly true in transactions where, as the Court of Appeals for the Second Circuit noted in *Gilman*, there can be more than one "reasonable estimate" of future economic events.[6] Pet. App. 13a.

The Commissioner's position in this case also overlooks the important role of this Court in providing guidance and clarification to the lower courts, to taxpayers and to government

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6 The Commissioner's reliance upon "reasonable" predictions of future economic events also places an inappropriate burden on the courts as finders of fact. The instant case is a typical example, involving as it did a number of experts attempting to predict the unpredictable. Not surprisingly, those experts made vastly disparate predictions as to "reasonable" estimates of the future value of Gilman's equipment. Some of those predictions would result in a profit, others in a loss. Trial courts should not be forced to divine which expert's subjective prediction would have been most "reasonable" years earlier to determine whether a transaction is a sham.

officials who are engaged in the administration of the tax laws. It is an appropriate function of this Court to provide guidance on matters of basic principle in areas which are constantly recurring in tax administration and in the courts. This is especially true where, as in cases such as this, the question is one of importance on which numerous business persons and their lawyers need guidance in order that they may structure transactions with reasonable assurance that controversy and litigation are not inevitable.

Finally, the issues presented in this petition arise in nearly all tax shelter cases. By resolving the conflicts between the circuits described in this petition, this Court can forestall the needless litigation that would crowd the dockets of the lower courts.

CONCLUSION

The petition for a writ of certiorari should be granted.

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January 2, 1992